

## Payout by Charities Over 50 Years

By Calvin H. Johnson



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This proposal would require a section 501(c)(3) charitable organization to spend or distribute a gift, both as to principal and interest, over the 50 years following receipt of the gift. The goal of the rule is to increase the good that comes from charitable deductions and reduce the administrative burden. Within broad definitions of charity, the worthiness of a charity is defined more by process than by detailed substantive rules — a donor can be presumed to be trying to do the most good with his money. The world changes over time, however, and after 50 years it is different. The 50-year payout requirement would strengthen the tie between the wisdom of the donor and the most pressing needs of the times.

The requirement would also diminish the problems from charitable boards that are accountable on substance to nobody but themselves. A board without competition, recent donations, or meaningful substantive accountability should lose its special claim to control the money over time. A charity with continuing support, however, would not go out of business. The accounting would treat the earliest gifts as given out first, so that an active charity with both new contributions and high expenditures would have long since distributed its old funds.

This proposal is made as a part of the Shelf Project, which is a coalition to improve the efficiency and rationality of the income tax. Shelf Project proposals raise revenue, while also making the tax system more efficient and reducing deadweight loss. For tax rate increases, by contrast, deadweight loss is an additive, not an offset. Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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### A. Current Law

A charity of the donor's choice or creation has priority over the federal government under both the income tax and the estate tax.<sup>1</sup> Federal taxes would take as much as 35 percent of income and 35 percent of an estate, but by reason of the deductions for contributions to a charity, the government defers to the charity in both taxes.

The rationale for the deduction depends critically on the desire of the donor to direct resources where they will do the most good. As Prof. Evelyn Brody argues:

Our legal structure excels at establishing or requiring processes in which individuals may make substantive decisions, but it falters at dictating results. Consistent with their limited

role in our political economy, the best laws assist private parties in enforcing their agreements; the worst laws tell private parties what their agreements should be.<sup>2</sup>

In a process-based system, it is of critical importance not to allow the charitable deduction to extend to resources the taxpayer has kept for himself<sup>3</sup> — if self-serving can qualify as deductible charity, then the gifts to one's self will dominate. Still, if self-service were eliminated, a process approach would rely on the donor. We defer to the donor to find a best use for the money.

The statute and case law do have some broad, fuzzy-bordered limitations on what qualifies as charity, but the limitations do not ensure that the funds are being spent for their best use within the categories. The charity, for qualification for the charitable deductions, must fit within the broad categories of religion, relief of poverty, science, education, literature, amateur sports competitions,

<sup>1</sup>Section 170(a) (charitable deduction for income tax); section 2055(a)(2) (charitable deduction for estate tax).

<sup>2</sup>Evelyn Brody, "The Limits of Charity Fiduciary Law," 57 *Md. L. Rev.* 1400, 1405 (1998). Prof. Brody is the reporter for the American Law Institute's project on Principles of the Law of Nonprofit Organizations.

<sup>3</sup>See, e.g., Calvin H. Johnson, "Ain't Charity: Disallowing Deductions for Kept Resources," *Tax Notes*, Aug. 2, 2010, p. 545, *Doc 2010-15394*, or *2010 TNT 150-10* (limiting deductions, e.g., to adjusted basis of property, and when taxpayer attends the service).

or prevention of cruelty to children or animals.<sup>4</sup> There can be no private inurement from the charity to the donors or managers, and no substantial portion can go for political campaigns or lobbying.<sup>5</sup> Public policy prevents a section 501(c)(3) organization from being racially discriminatory<sup>6</sup>: The organization cannot be a school for pickpockets.<sup>7</sup> Within the vague limits, however, the donor sets the goals. We occasionally allow deductions for expenses like the care of cats (for example, 70-80 cats in the taxpayer's home), but notwithstanding possible errors, we rely on donors.<sup>8</sup>

Under current law, a charitable organization can have a perpetual life. Under traditional common law, they were free from the law against perpetuities, which has traditionally limited the life of non-charitable trusts.<sup>9</sup>

A private foundation, created by the donations from a single donor or family, must pay out 5 percent of the value of its investment assets on grants and expenses in every year.<sup>10</sup> There is an exception allowed if the private foundation gets IRS approval for a specific project that would be better accomplished by deferred payments for as much as five years — for instance, the construction of a building.<sup>11</sup> Publicly supported charities, including donor advisory funds that mimic private foundations but aren't subject to the special rules for private foundations, are not subject to the payout requirements.

## B. Reasons for Change

There needs to be a temporal limitation to our deference to donors in the charitable deduction. Giving supremacy to the donor's decision over the revenue may have been wise when the donation

was made, but as the world changes, the donor's wisdom is less well connected to the needs. Donor decisions that were intended to achieve the most good for the resources when made eventually stop achieving that goal and actually begin to impede the optimal decisions. The decisions in detail as to how to use the funds, moreover, are made by the boards and managers of charitable entities who are accountable in substance to nobody but themselves. A board accountable to no one loses its legitimacy over time and does not justify its own administrative expenses. With every passing year, the good accomplished by the charitable deductions decays both because the organization will drift from the donor's legitimacy and the world will drift from the donor's world. Under the proposal to require the charity to use its gifts within a limited period, all use of the funds would remain charitable and within the donor's instructions, but the use would have been accomplished earlier and therefore more effectively. Charitable institutions that continue to draw support from donors would continue in existence and for the mission they articulate, even after using up their old gifts. Charities without continuing support would wither and disappear.<sup>12</sup>

**1. The future is different.** Nobody knows what the world is going to be like in 100 years, except that the future will be very different. Wise judgments on use of resources made now are not likely to be the optimal decisions in the future. Charitable needs change. A charity set up to provide for sanatoriums for tuberculosis in the 1940s, for example, was helping to fill an important social need, but tuberculosis responds to antibiotics, and the sanatoriums are no longer needed. A charity set up to fight small pox has apparently entirely lost its target. With the polio vaccine, polio is no longer the scourge that it was. We should probably expect surprising new scourges in the future, much as AIDS was a surprise, but it is not clear that we can know now from what direction a scourge will come and how best to respond to it.

The future will be better able to identify its most pressing problems. On average, a donor is no smarter or more farsighted than his times allow him, and when the times change, the foresight can no longer see it. We should let the future decide how best to use its resources.

<sup>4</sup>Section 501(c)(3).

<sup>5</sup>*Id.*

<sup>6</sup>*Bob Jones Univ. v. United States*, 461 U.S. 574 (1987) (no racial discrimination).

<sup>7</sup>*Id.* at 617-618 (Rehnquist, J., dissenting) (no "Fagin School for Pickpockets").

<sup>8</sup>*Van Dusen v. Commissioner*, 136 T.C. No. 25 (2011), *Doc 2011-11985*, 2011 TNT 107-7 (allowing taxpayer a deduction for \$12,000 costs for keeping 70-80 feral cats in her home, including food, vet bills, litter, some utility costs, paper towels, garbage bags, and undoubtedly, air freshener).

<sup>9</sup>See, e.g., Restatement (Second) of Trusts section 365 (saying that a "charitable trust is not invalid although by the terms of the trust it is to continue for an indefinite or an unlimited period"). The trend for states to extend the perpetuities period or repeal duration limits for non-charitable trusts is described, for instance, in Mark Ascher, "But I Thought the Earth Belonged to the Living," 89 *Tex. L. Rev.* 1149 (Apr. 2011) (reviewing Lawrence M. Friedman, *Dead Hands: A Social History of Wills, Trusts and Inheritance Law* (2009)).

<sup>10</sup>Section 4942.

<sup>11</sup>Section 4942(g)(2)(B)(i). There are also automatic exceptions to the 5 percent payout rule for a startup foundation.

<sup>12</sup>See Ray Madoff, "Immortality for Foundations Can Pose Big Challenges in Shifting Times," *Chron. of Philanthropy* (Oct. 31, 2010). Madoff suggests that both law and donors should limit private foundations to a 50-year life. See also Madoff, *Immortality and the Law: The Rising Power of the American Dead*, 86-118 (2010) (criticizing perpetual life allowed for charitable trusts).

Early spending, as a general rule, will increase the good accomplished. Early contributions can sometimes nip a problem in the bud before it grows to become a serious social problem.<sup>13</sup>

The future, moreover, will be richer than we are, if per capita GDP continues to rise, and in general, a dollar spent when we are comparatively poor will do more good than when we are comparatively rich. If we grow richer, saving now for future generations is like reverse Robin Hood: stealing from the comparatively poor for the comparatively rich. And as we grow richer, we should expect new foundations to be formed by billionaires as a part of their estate planning. And if we are not richer in the future, it will undoubtedly be for reasons that we cannot now anticipate.

Conversely, some expenses are rising in real terms, including, for example, college tuition. If a donor leaves money in trust to give scholarships so that promising students can get an education at the University of Texas at Austin,<sup>14</sup> one might expect the money to give three full-tuition scholarships now for every one scholarship in the future because of the increase in tuition. The benefits of education are also passed to the next generation so that educating students now will have continuing benefits on future generations.

Cy pres (meaning "as near as possible") allows a court to modify the original instructions of the donor when the original purpose of the charity has become impossible or impracticable and the terms of the trust do not specify what is to happen in that situation. The Uniform Trust Code, for instance, codifies the common-law cy-pres doctrine, providing that "if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful . . . the court may apply cy pres to modify or terminate the trust . . . in a manner consistent with the settlor's charitable purposes."<sup>15</sup> Cy pres, however, follows the donor's commands in place insofar as they are not impossible or impracticable, even if they are no longer able to get the resources to the most pressing need of the times.

Donors should understand that once they are gone, a great and permanent institution will be formed only by persuading people of future generations to support the institution. John Harvard and Eli Yale were able to support long-lasting institutions only because people decided to support

those schools long after their deaths. Institutions without the continuing re-invigoration from the living will and should wither.

Because of the deduction, the government has a stake in the optimal use of the resources so that the decision as to what kind of gifts to allow as deductions is not entirely a matter of donor discretion. Charitable contributions are considered a tax expenditure; that is, a government cost for which the government needs to exercise responsibility to avoid waste.<sup>16</sup> Forcing earlier spending for the donor's charitable purpose will force more efficient spending and improve the efficiency of the tax expenditure because the understanding of the donor will better fit the situation. When a charitable deduction is taken at end of life and saves maximum tax for both the income tax and estate tax, the federal government has the majority stake or economic burden (as much as 54 percent under current rates).<sup>17</sup> States also sacrifice revenue in allowing a charitable deduction, but their rates are much lower and the state taxes are deductible from federal tax, so their stake is far lower.

The proposal here also would require gifts from the general public to be paid out over a limited time. Public charities raise funds by soliciting the general public and differ from private foundations, which are founded by a single donor or family. Even the public understanding of what needs to be done will grow out of date, however, given that no one can predict the future.

A charitable trust or foundation, moreover, is managed by a board and managers who over time will drift from the donor's original vision. Lewis B. Cullinan has advocated a fixed life for foundations because "when you set up a family foundation and turn it over to bureaucrats, it is not human nature [for them] to vote [themselves] out of existence. It's

<sup>16</sup>The charitable deduction is listed as a tax expenditure by both the congressional and administration inventories of tax expenditures. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014," JCS-3-10 (Dec. 15, 2010), at 32, *Doc 2010-27177, 2010 TNT 245-12*; Office of Management and Budget, "Analytic Perspectives, U.S. Budget, Fiscal Year 2010," at 242.

In parallel, the government is responsible for the waste resulting from too loose a definition of research for the purposes of the expensing of research and experimentation and the credit given for research and development. Johnson, "Capitalize Costs of Software Development," *Tax Notes*, Aug. 10, 2009, p. 603, *Doc 2009-15569, 2009 TNT 151-9*.

<sup>17</sup>If a taxpayer has \$100x income subject to 35 percent tax and would pay 35 percent estate tax on what is left, her successors are left with  $\$100x \times (1-35 \text{ percent}) \times (1-35 \text{ percent})$  or  $\$42.25x$  after tax. Thus a gift to charity would deprive her successors of  $\$42.25$  and would deprive the federal government of the rest, or  $\$57.75x$  of the gift.

<sup>13</sup>Akash Deep and Peter Frumkin, "The Foundation Payout Puzzle" (2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=301826](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=301826) (citing Irene Diamond Foundation, which spent a significant portion of its endowment and found the HIV inhibitor).

<sup>14</sup>A worthy goal, recommended to readers.

<sup>15</sup>Uniform Trust Code section 413(a).



time to end that, for the good of us all.”<sup>18</sup> Donors sometimes do set a fixed life for a charitable fund to prevent drift from the donor’s vision,<sup>19</sup> although fixing a life for the foundation is hardly the universal pattern. The problem is also related to governance of charitable boards and managers, discussed next.

**2. Accountable to no one.** Charitable organizations are responsible to no one but themselves, which means that their legitimacy, drawn from their donors, will decay over time unless they get new donors. As Brody puts it, a charity is “an entity having no owners and established for the benefit of indefinite beneficiaries.”<sup>20</sup> Without either owners or identifiable beneficiaries, “Who is the principal on whom the law can rely to monitor the agents and enforce the charitable purposes?” Brody asks.<sup>21</sup>

Judge Richard A. Posner for similar reasons has recommended that a charitable foundation be required to distribute its endowment including income within a specified period of years to strengthen the governance of a foundation:

A charitable foundation that enjoys a substantial income, in perpetuity, from its original endowment is an institution that does not compete in any product market in the capital markets and that has no shareholders. Its board of trustees is self-perpetuating and is accountable to no one (except itself) for the performance of the enterprise. (Although state attorneys general have legal authority over the administration of charitable trusts, it is largely formal.)<sup>22</sup>

A virtue of requiring payout of old gifts, according to Posner, would be to require the charity to get new donations if it is to survive: “Since donors are unlikely to give money to an enterprise known to be slack, the necessity of returning periodically to the market for charitable donations would give trustees and managers of charitable foundations an incentive they now lack to conduct a tight operation.”<sup>23</sup>

<sup>18</sup>Quoted in James Panero, “The Best Way to Really Give Away Money,” *The Wall Street Journal*, Aug. 20, 2010.

<sup>19</sup>Both the right-of-center Olin Foundation (1954-2003) (see Jason DeParle, “Goals Reached, Donor on Right Closes Up Shop,” *The New York Times*, May 29, 2005) and the left-of-center Field Foundation (1940-1989) (see “History of the Field Foundation” (draft with written corrections and comments)) distributed their money and went out of business within 50 years of their founding or the donor’s death. Similarly, the Atlantic Foundation is dedicated to making large gifts now and distributing all it has by 2020. See the Atlantic Foundation, “What We Believe,” available at <http://www.atlanticphilanthropies.org/what-we-believe>.

<sup>20</sup>Brody, *supra* note 2.

<sup>21</sup>*Id.*

<sup>22</sup>Richard Posner, *Economic Analysis of Law*, 558 (5th ed. 1998).

<sup>23</sup>*Id.*

For testamentary gifts, the decedent no longer can give directions or advice. Even for gifts during life, once the gift is completed, the donor will lose control of detailed decisions. Indeed, many states give donors limited standing even to enforce explicit restrictions once the gift has been completed.<sup>24</sup>

The attorney general of each state has the power to supervise charities and prevent misappropriation of funds.<sup>25</sup> Most states require charitable entities to make regular reports to the AG.<sup>26</sup> The state AGs, however, rarely have the funding or incentives to engage in aggressive charity enforcement.<sup>27</sup> Most state AGs assign few (if any) lawyers to supervise the charity.<sup>28</sup> Notwithstanding the supervision of the AGs, there have been recurring scandals at even the biggest and well-known charities in which the managers pay themselves excessive salaries and misappropriate funds for personal expenses.<sup>29</sup> State AGs, moreover, have their own agendas — they tend to be intensely political actors, and their focus can be expected to be parochial to try to limit the charity to the state in which they are elected. Supervision by the AG can sometimes do more harm than good.<sup>30</sup>

The state AGs have done poorly in preventing misappropriation, which is within their power and

<sup>24</sup>Iris Goodwin, “Donor Standing to Enforce Charitable Gifts: *Civil Society v. Donor Empowerment*,” 58 *Vand. L. Rev.* 1093 (2005).

<sup>25</sup>Restatement (Second) of Trusts section 391, (1959) (A “suit to enforce a charitable trust can be maintained by the Attorney General of the State in which the charitable trust is to be administered.”); Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation*, 305 (2004) (discussing power of state AGs to oversee charitable trusts).

<sup>26</sup>Susan N. Gary, “Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law,” 21 *U. Haw. L. Rev.* 593, 619-622 (1999) (collecting state and federal disclosure rules).

<sup>27</sup>Brody, “Whose Public?: Parochialism and Paternalism in State Charity Law Enforcement,” 79 *Ind. L. J.* 937 (2004).

<sup>28</sup>See Garry W. Jenkins, “Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law,” 41 *Ga. L. Rev.* 1113, 1128 (2007) (reporting recent surveys).

<sup>29</sup>See Jesse Dukeminier, Stanley M. Johanson, James Lindgren, and Robert H. Sitkoff, *Wills, Trusts, and Estates*, 763-766 (2005) (describing extensive misappropriation of trust assets and mismanagement by trustees of Hawaii Kamehameha Schools/Bishop Estate); Karen Donnelly, “Good Governance: Has the IRS Usurped the Business Judgment of Tax Exempt Organizations in the Name of Transparency and Accountability?” 79 *UMKC L. Rev.* 163, 173-174 (2010) (excessive compensation or misappropriation of funds at United Way, Smithsonian Institution, American Red Cross, and the Nature Conservancy).

<sup>30</sup>Jonathan Klick and Robert H. Sitkoff, “Agency Costs, Charitable Trusts and Corporate Control: Evidence From Hershey’s Kiss Off,” 108 *Colum. L. Rev.* 749 (2008) (showing that stock market thought that the Pennsylvania AG’s blocking of sell-off of Hershey stock by foundation destroyed \$2.7 billion in value).

responsibilities. They have no authority to supervise use of funds that are within the broad definitions of charity. Thus, if a foundation is dedicated to education, the decisions as to what to spend the money on are entirely within the discretion of the board and the managers. For example, if a charitable trust is dedicated to education, the board will decide which applicants will get a scholarship and what guidelines will help its decisions. The board may have the full discretion to decide whether education is furthered best with a gift toward a hard asset like a library or a science lab, or softer assets such as a professor's salary or research on teaching effectiveness. While the board has the discretionary power of an owner within the limits of the donor's instruction, it has legitimacy for decisions only as given by the donors. Once the donor's vision has faded as the world changes, we need to worry that the foundations will be kept alive opportunistically by the people who control them, so as to provide management a job with good benefits. We defer to the wisdom of the donor, but it is not clear by what principle we defer to management to exercise the discretionary powers allocating the funds within a broad definition.

A charitable trust or foundation can incur high expenses. The Better Business Bureau has adopted a code of standards that it advocates that charities should follow.<sup>31</sup> The standards, for example, say that the administrative expenses should not exceed 35 percent of fund income. That is not a very rigorous standard. If the fund were taxable, the government's share would not exceed 35 percent. Moreover, the bureau is advocating aspirational standards, so that presumably some charities spend a lot more than 35 percent of income on their expenses. There is a natural tendency for any manager with power over money to first ensure that managers are well provided for. Public policy needs to be demanding enough to ensure the charitable use gets priority over manager benefits. A charitable trust that spends more in expenses to support the managers than it adds in value needs to spend its funds now and go out of business.

**3. Why 50 years?** A case for requiring a charity to distribute contributions received over some period of time does not set a specific term. The standard advocated here is that the contribution should be fully spent or distributed by the time that the average donor's instructions will be likely to generate less optimal use than an unfettered charitable decision because of changes in the world and a shift in

its greatest problems and because of the losses in efficiency because charitable boards cannot be regulated.

One hundred years is too long. Nobody has any idea what the world will be like in 100 years, especially with the pace of change accelerating, except to know that the world, if it exists, will be different. Requiring distributions within say, two years, would prevent the charity from developing a program that requires some learning and experience to perfect.

There are several reasons for the proposal, which would require distributions over 50 years. First, a left-of-center foundation (the Field Foundation) and a right-of-center foundation (the Olin Foundation) adopted the 50-year line, after consideration,<sup>32</sup> and they are models, across any partisan line.

Second, a 50-year life assumes the donor knows something of the world of his grandchildren, but not of his great-grandchildren. A generation is the average age of the mother at the birth of her first child: In the United States, the length of a generation is now 25 years.<sup>33</sup> A donor needs to understand the world of his children — even if things like Twitter and Grand Theft Auto seem strange, they are within his responsibility. It is less likely that the donor will understand the world of his grandchildren, and very unlikely that he will understand the world of his great-grandchildren. A 75-year payout would mean that the donor would still be making the decisions for his great-grandchildren's generation, which seems too far in the distance for the donor's decision to more likely than not be optimal. For testamentary gifts, a 50-year payout would mean that all the donor's children are likely to be dead.<sup>34</sup>

Fifty years ago today would mean that the donation was made before the assassination of President Kennedy. One might say that the world was a different place before the assassination of John and Robert F. Kennedy, and of Martin Luther King Jr. Fifty years ago is before the United States had entered the war in Vietnam.<sup>35</sup>

There are alternative dates. The world was different before Pearl Harbor (1941), implying a 70-year period for use of contributions. Or the world

<sup>32</sup>See *supra* note 19.

<sup>33</sup>T.J. Mathews and B.E. Hamilton, "Delayed Childbearing: More Women are Having their First Child Later in Life," National Center for Health Statistics (2009), available at <http://www.cdc.gov/nchs/data/databriefs/db21.pdf> (in 2006 average age of mother at birth was 25 years).

<sup>34</sup>The statement assumes the last child was born at donor's age 35 and that both donor and youngest child live to be 85.

<sup>35</sup>I date U.S. entry into Vietnam War from the Tonkin Gulf Resolution (P.L. 88-408) in 1964, even though the United States had military advisers in Vietnam before that.

<sup>31</sup>Better Business Bureau, Standards for Charity Accountability para. 9 (2011), available at <http://www.bbb.org/us/Charity-Standards/>.

was different before mass production of penicillin in 1945 (implying a 66-year life) or before President Truman integrated the armed forces in 1948<sup>36</sup> (63-year life). The world of international security and relations was also very different before the Berlin Wall fell (1989, 23 years). For different charity goals, there are different plausible dates. Whatever the specific period, at some point the donor's understanding of the world, which is the reason the government defers to the donor, will no longer be the best fit to the most pressing problems of the times because the world has changed.

The pace of change seems to be increasing. If by some unit of measurement the world changes by 2 percent a year, then in 50 years it will be 64 percent different.<sup>37</sup> At 75 years, the world would be 79 percent different.<sup>38</sup> In either case, if that is the rate of change, the donor's decision for optimal use of resources will be mostly wrong.

The 50-year limitation would be a modest limitation on donors. The first 50 years of the life of an investment has most of the value under net present value concepts. Assume a 3 percent discount rate and a fund that is perpetually worth \$100x, because it is like a bank account perpetually giving out income equal to current discount rate. The first 50 years of the fund are worth \$77x at 3 percent, but the remaining life from 50 years hence and stretching on in perpetuity is worth only \$23x.<sup>39</sup>

**4. Reaffirmation.** The requirement that gifts be distributed over 50 years would not require a charitable institution to go out of business in 50 years if it is getting continuing contributions. A charitable endowment with a 50-year payout requirement would be like a leaky bucket with a hose in it; water would drip out under the use or distribution requirement, but as long as the hose puts more in, the water level would rise. That is as it should be. The new contributions add recent legitimacy to the use of the funds because they represent donors' best and recent judgment. The legitimacy given by old gifts leak out.

<sup>36</sup>Executive Order 9981 (1948).

<sup>37</sup>Thus, 100 units times  $(1+2\%)^{50}$  equals 36 units, which is 64 units different from the start. If we view the change not as a delay but a growth, then 100 units times  $(1+2\%)^{50}$  equals 275 units, and the current units are 100 divided by 275, or 37 percent of the future.

<sup>38</sup> $100 \text{ units} * (1-2\%)^{75} = 22 \text{ units}$ .

<sup>39</sup> $\$100x / (1+3\%)^{50} = \$23x$ . The argument comes from Brody reporting for the American Law Institute, Principles of the Law of Nonprofit Organizations Project, Tentative Draft No. 2, section 440 (2009), and I am grateful to her for pointing it out. The \$23x means that if \$23x were deposited now in an account giving 3 percent annual interest, then it would have grown in 50 years to be worth \$100x and would thereafter give the same \$3x income in perpetuity as the \$100x gives today.

For the great, active charitable institutions, the requirement of use or distribution over 50 years would not have any effect because the accounting would treat the oldest gifts as distributed first. The first-in, first-out accounting method would apply even if the charity — for its own internal purposes or under the terms of the gift — treated the gift as a perpetuity; that is, with a corpus preserved forever. An active charity that spends more on its current activities on net makes on its endowment will find that it has long since spent out its oldest funds that might be in jeopardy. A charity spending more on its charitable activities than its income from fees for services (for example, tuition) and investment portfolio would still grow, but only by the amount that new contributions exceed the deficit.

### C. Explanation of the Proposal

**1. Accounting.** The charity should be required to use or distribute both its income and the corpus of the gift over the 50-year period. The same considerations that imply the 50-year period imply that earlier is better. The charity should not distribute everything all at once at the end of the 50-year period. A norm should be that the charity will pay out funds at least as fast as the annuity that will distribute all the gift over 50 years. Thus, a charity making a 5 percent return on its funds will meet its 50-year payout if it spends or distributes 5.48 percent of its funds every year.<sup>40</sup> A charity should be allowed to save up its funds for a grand project like a library or cathedral, but if it falls behind the annuity schedule that would distribute everything evenly, then it should have prior IRS approval on a showing that the deferring payout (for as much as five years) would better service an identifiable project.<sup>41</sup>

The proposal would treat the land, equipment, and buildings that are customized to a charitable purpose as if they were immediate expenditures of charitable funds, even in the face of financial theory that says that tangible buildings and equipment are an investment, much like stocks and bonds. Portfolio investments in buildings not used for charity, however, would be treated as investments which, with the income, would be required to be distributed over the 50 years.

Payments received for goods and services, including tuition, entrance fees, rental income, and

<sup>40</sup>The 5.48 percent would be sufficient payout under the standard formula for present value of an annuity  $(5.48\% * [1 * (1-(1+5\%)^{-50}) / 5\%] = 100\%)$ .

<sup>41</sup>Cf. section 4942(g)(2)(B)(i) (allowing private foundations to avoid the requirement that they pay out 5 percent of assets annually for projects to be accomplished within five years that are better accomplished by delayed payout, as approved by the IRS).



shop sales, would not be considered contributions, whether they related to the charitable activity or not. They would first be offset against the charity's cost of its activities and thereafter would be considered income, just like investment income. Income does not have its own separate 50-year schedule but must be distributed in general as a part of a 50-year annuity schedule.

Income varies from year to year, and the annuity schedule should be set by a five-year rotating average of returns. During inflationary periods, the charity will be making higher payoffs that are appropriate to its needs in inflationary time. The easiest, fairest, least manipulable rule would be that the income of the entire charity's investment would be applied to compute the annuity for any one gift, but if there is a fund administered as a separate investment portfolio that is earmarked with the gift since it was given and does not just support other endowment investments, the charity should be allowed to use the income from the specific fund if that makes it easier to compute the payout schedule for that fund. As described in regulations, the charity should be able to use some pools and conventions — such as all gifts are received on July 1 — to make the accounting simpler. It would be reasonable to have a cushion, in case the charity falls behind the annuity schedule, even without a plan to save up for the library (or cathedral), except that whatever the border is, it will be a precise one in which things go from permitted to not permitted. Because a border is necessary, the annuity is a reasonable border: A charity can always be ahead of the annuity schedule for its cushion.

With considerable reservation, it is recommended that distributions to another charity would qualify as the expenditure of charitable funds. A gift to the endowment of another charity does not truly spend the money for charity, but merely defers the good use for another period. We should be concerned about a circle of charities in which each charity complied with the 50-year rule by distributing funds to the others in the circle. Each distribution would start a new 50-year period, and the total would be a perpetual circle with no new donor re-validation. With reservations, it is recommended that the distribution to another charity would qualify for the mandatory payout. The proposal would, however, require that the recipient charity be a public operating foundation (and not a donor advisory fund) and that there be no overlap of management or family relationship or prior donations.

The 50-year payout requirement would be enforced primarily by making the rule part of the necessary qualification of an entity under section 501(c)(3). The requirement of payout over 50 years

on an annuity schedule would be part of the bylaws of the charity enforced by state AGs. But enforcement should also be by the IRS: Failure to pay out over 50 years on the annuity schedule (or an annuity schedule with allowance for saving for big projects and a cushion) would be taxable. If the violation is within 10 percent of the required payout, the income accumulated by the foundation but not paid out would be subject to the highest rate of either corporate or trust tax.

After a cushion, however, enforcement of charitable uses needs to be enforced by a 100 percent tax on funds not spent. Thus, funds accumulated in excess of the 10 percent cushion or funds accumulated after notice should be subject to a 100 percent tax: Gifts qualifying for the deduction may not revert to a donor or his heirs,<sup>42</sup> so it is not sufficient that funds just become taxable. The full after-tax amount needs to go toward charitable uses as well. The 100 percent tax would probably rarely apply because the managers would spend the money on a charity that is not the United States government, but the 100 percent tax would induce the earlier and better use for charitable purposes.

**2. Alternative of taxing the charity.** Prof. Daniel Halperin, reacting to many of the same concerns as those behind this proposal, has proposed that charitable investments be subject to income tax, even within a section 501(c)(3) organization.<sup>43</sup> The tax on investment income sometimes seems inappropriate if the funds are expended for charitable purposes. Thus, even if the fund were a taxable organization gaining no tax advantage, still we would ordinarily allow it a deduction for expenses of its business and for making charitable contributions. Money actually spent for charity thus does not seem appropriately taxed. Moreover, once a donor's wisdom is out of date, and the charity is managed by an unreviewed board, the appropriate remedy is to get the funds out of the charitable organization and used or distributed for charitable purposes. After taxes have been paid, the funds should not be left within the control of a board and managers who have lost their mandate.

<sup>42</sup>Reg. sections 1.170A-1(e) and 25.2522(c)-3(b)(1) (providing that no deduction is allowed if the gift may revert unless the possibility is so remote as to be negligible).

<sup>43</sup>Daniel I. Halperin, "Does Tax Exemption for Charitable Endowments Subsidize Excessive Accumulation?" (June 10, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1143458\\_10](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1143458_10).